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FEDERAL COMMUNICATIONS COMMISSION
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June 18, 1998

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Magalie Roman Salas
Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: Petition on Defining Certain Incumbent LEC Affiliates as
Successors, Assigns, or Comparable Carriers Under
Section 251(h) of the Communications Act;
CC Docket No. 98-39

Dear Ms. Salas:

On behalf of the Competitive Telecommunications Association ("CompTel"), the Florida Competitive Carriers Association ("FCCA"), and the Southeastern Competitive Carriers Association ("SECCA"), I am writing to notify you that Genevieve Morelli, Executive Vice-President and General Counsel of CompTel, Joseph Gillan, and I made two *ex parte* presentations today regarding this proceeding: to John Nakahata, Chief of Staff, and Thomas Power, Legal Advisor to Chairman Kennard, and, separately, to Kevin Martin, Legal Advisor to Commissioner Furchtgott-Roth. We used the attached handouts during these presentations.

Respectfully submitted,

David Sieradzki

David L. Sieradzki
Counsel for CompTel, FCCA, and
SECCA

Enclosures

cc: John Nakahata
Thomas Power
Kevin Martin
Parties on attached service list

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June 16, 1998

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1919 M Street, N.W.
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Dear Ms. Salas:

On behalf of the Competitive Telecommunications Association ("CompTel"), the Florida Competitive Carriers Association ("FCCA"), and the Southeastern Competitive Carriers Association ("SECCA"), I am writing to notify you that Genevieve Morelli, Executive Vice-President and General Counsel of CompTel, and I made an *ex parte* presentation today regarding this proceeding to James Casserly, Legal Advisor to Commissioner Ness. We used the attached handouts during this presentation.

Respectfully submitted,



David L. Sieradzki
Counsel for CompTel, FCCA, and
SECCA

Enclosures

cc: James Casserly
Parties on attached service list

June 1998

Competitive Telecommunications Association, Florida Competitive Carriers Association, and Southeastern Competitive Carriers Association

Section 251(h) Petition – CC Docket No. 98-39

1. **Introduction: Who We Are**
2. **Background: ILECs are Setting Up “CLEC” Affiliates to Provide Local Service Within the ILECs’ Service Areas**
 - BellSouth, Ameritech, GTE, are setting up *alter ego* “CLECs.”
 - These entities provide the same local exchange and exchange access services as the ILECs, in the same geographic areas, using the same (or similar) brand names, and using the same corporate resources.
 - It is clear that the ILEC and “CLEC” entities are ultimately subject to the same management, and are operated to advance common corporate objectives. (BellSouth describes its BellSouth BSE unit as a form of “brand extension.”)
3. **The Problem: ILEC Evasion of Section 251(c) Interconnection and Local Competition Obligations Through “CLEC” Affiliates**
 - ILECs can evade Section 251(c)(4) resale obligations by offering customer-specific contract service arrangements and other services, formerly available from the ILECs, through their “CLEC” affiliates.
 - In this way, ILECs can use their “CLECs” to impose a price squeeze on *real* CLECs that depend on service resale, with very limited risks to the overall ILEC corporation’s bottom line.
 - ILECs can funnel investment in upgraded network facilities into “CLECs” in order to evade their Section 251(c)(3) unbundled network element obligations.
 - ILECs could evade FCC access charge and price cap rules by offering service through “CLECs,” purportedly on a non-dominant basis.
 - Some state commissions have denied certification to such in-region ILEC-“CLECs,” or placed restrictions on such certifications. The fact that the issue has been presented to so many state commissions demonstrates the urgent need for FCC action.

4. The Solution: Section 251(h)

- Issue a declaratory ruling establishing a *rebuttable presumption* that, under Section 251(h)(1), entities will be considered “successors” or “assigns” of ILECs -- and will be subject to ILECs’ Section 251(c) and dominant carrier obligations -- if they are:
 - ILEC affiliates (Section 3(1) of the Act);
 - Provide wireline local exchange or exchange access service in same geographic area served by the ILEC; and
 - Operate under the same or similar brand names (shows transfer of resources that are of value in providing local service).
- In the alternative, initiate a rulemaking to establish, by rule, a rebuttable presumption that such entities are “comparable carriers” under Section 251(h)(2).
- The Commission has authority to adopt the requested rulings:
 - Section 251(h) and relevant case law support piercing the corporate veil to prevent evasion of regulatory rules through *alter ego* corporate entities.
 - The *Non-Accounting Safeguards Order* does not squarely address the circumstances raised by our petition, but it generally provides support for the relief requested.

5. The Context: Related Proceedings

- ILEC resistance to local competition: state proceedings; Supreme Court review of *Local Competition Order*; Section 271 applications.
- Section 706 Petitions of BOCs, ALTS, and APT, and Upcoming Section 706 Proceeding.
- LCI Structural Separation Petition.

STATE CONSIDERATION OF ILEC IN-REGION "CLEC" AFFILIATES

STATE	ILEC	DECISION	DATE
AL	BellSouth	Permitted.	2/2/98
CA	Pacific Bell	Withdrawn after negative ALJ preliminary decision	5/6/97
CA	GTE	Permitted for wireless affiliate.	2/23/96
CT	SNET	Permitted in context of restructured relationship between ILEC and retail affiliate.	6/25/97
FL	BellSouth	Proceeding in progress - no decision issued.	N/A
FL	GTE	Permitted, but did not analyze relationship with ILEC.	2/24/97
GA	BellSouth	Permitted with conditions (e.g., ad disclosures; separate books, records, accounts; separate officers, directors, employees; no creditor access to ILEC assets; independent audits; arms-length transactions)	3/5/98
KY	BellSouth	Rejected in BellSouth service areas.	6/8/98
MI	Ameritech	Rejected until FCC grants ILEC 271 relief.	8/28/96
NC	GTE	Permitted, but did not analyze relationship with ILEC.	4/16/97
SC	GTE	Permitted, but did not analyze relationship with ILEC.	9/12/97
SC	BellSouth	Permitted, but did not analyze relationship with ILEC.	12/23/97
TX	GTE	Rejected in GTE service areas.	10/30/97
WI	Ameritech	Permitted only until FCC ILEC 271 relief, for the provision of local service through resale only, and subject to conditions (e.g., no preferential treatment by ILEC, no access to ILEC CPNI or network information, no ILEC subsidization, affiliate transaction requirements).	11/26/96

STATE DECISIONS ON SPRINT "CLECS"

FL	Sprint	Permitted, but did not analyze relationship with ILEC.	12/27/95
KS	Sprint	Permitted, but did not analyze relationship with ILEC.	8/7/96
MO	Sprint	Not applicable -- certification not sought within Sprint ILEC service area.	2/28/97
NB	Sprint	Not applicable -- certification not sought within Sprint ILEC service area.	2/28/97
NV	Sprint	Permitted with conditions (e.g., ad disclosures; separate books, records, accounts; separate officers, directors, employees; no creditor access to ILEC assets; independent audits; arms-length transactions)	11/7/97
NJ	Sprint	Permitted, but did not analyze relationship with ILEC.	7/17/96
NC	Sprint	Permitted, but did not analyze relationship with ILEC.	3/7/97
PA	Sprint	Permitted, but did not analyze relationship with ILEC.	12/5/96
SC	Sprint	Permitted, but did not analyze relationship with ILEC.	12/3/96
TN	Sprint	Permitted, but did not analyze relationship with ILEC.	10/3/96
VA	Sprint	Permitted, but did not analyze relationship with ILEC.	11/8/96
WA	Sprint	Permitted, but did not analyze relationship with ILEC.	7/9/97

EXHIBIT 5

Income Statement

BellSouth BSE, Inc.

PRELIMINARY

(All numbers in 000s)

			1997	1998	1999	2000	2001	2002
Customers (000s)								
Number of Customers								
	Mass Market		-	325	954	1,154	1,187	1,242
	Business		-	13	39	66	82	118
Number of Access Lines								
	Mass Market		-	385	1,134	1,373	1,424	1,477
	Business		-	128	383	538	894	1,149
(0000s)								
Revenue								
	Mass Market		-	153,188	1,003,303	1,519,812	1,758,033	1,920,768
		Local/Intrastate		46,577	308,203	476,889	581,056	612,773
		Long Distance		11,308	67,879	83,753	102,867	112,366
				36,809	214,861	288,063	325,747	355,828
		Cellular		42,245	288,680	498,178	538,283	587,344
				548	3,736	5,915	6,879	7,618
		Internet		3,296	22,257	34,781	40,826	44,662
		Video		14,376	88,578	135,234	183,174	199,838
	Business		-	162,241	862,522	1,472,363	2,152,330	2,681,812
		Local/Intrastate		82,207	353,243	873,541	1,290,200	1,747,082
		Long Distance		70,034	398,280	598,822	862,130	934,731
	Total Revenue		-	315,400	1,865,825	2,991,874	3,911,363	4,602,580
Expense								
	Mass Market		-	-	-	-	-	-
		Cost of Services Sold (COSS)		118,519	781,586	1,221,109	1,373,849	1,424,806
		Sales, Service, General and Admin (SSG&A)		4,216	133,668	170,627	188,042	205,504
	Business		-	-	-	-	-	-
		COSS		120,334	682,258	823,349	1,292,170	1,505,395
		SSG&A		5,337	56,341	111,716	184,838	330,155
	Common	SSG&A		18,816	65,925	47,336	53,568	55,274
	Total Expense		-	28,369	482,886	1,753,602	2,578,942	3,521,134
	Gross Margin		-	(38,369)	(177,487)	202,383	418,432	1,081,434

Income Statement

BellSouth BSE, Inc.

PRELIMINARY

(All numbers in 000s)

	1997	1998	1999	2000	2001	2002
Depreciation	885	2,006	4,296	7,396	9,849	10,521
Property Tax	28	83	184	291	321	289
Gross Receipts Tax	-	2,839	17,902	26,628	35,202	41,423
Uncollectibles	-	8,482	88,675	74,799	87,784	82,351
Earnings Before Interest and Taxes	(28,962)	(181,894)	121,866	366,618	580,184	637,160
Taxes	(10,137)	(87,160)	47,410	118,347	230,177	365,486
Net Income	(18,825)	(124,735)	74,155	186,671	380,021	571,651
Free Cash Flow	(18,100)	(123,846)	(83,012)	80,795	273,328	494,845
Capital Spending						
Mass Market	1,901	528	846	162	1,811	473
Business	560	2,321	3,842	11,462	557	2,321
Common	3,199	5,810	9,856	6,233	3,199	5,910
Total Capital	5,660	8,759	14,144	16,858	5,667	8,704

Balance Sheet

BellSouth BSE, Inc.

All Numbers in \$000s.

	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
<u>Assets</u>						
Current Assets						
Cash	-	-	-	-	-	-
Accounts Receivable	-	53,618	332,490	508,636	664,932	782,437
Inventory	-	-	-	-	-	-
Total Current Assets	-	53,618	332,490	508,636	664,932	782,437
Property, Plant and Equipment						
Equipment	5,650	14,409	28,553	45,411	51,078	59,782
Accumulated Depreciation	565	2,571	6,867	14,264	23,913	34,433
Net PPE	5,085	11,838	21,686	31,147	27,166	25,348
Total Assets	5,085	65,456	354,176	539,783	692,097	807,785
<u>Liabilities</u>						
Accounts Payable	4,596	65,156	195,790	284,443	349,589	388,751
Deferred Taxes	215	805	1,725	2,802	3,278	2,987
Total Liabilities	4,811	65,962	197,515	287,245	352,868	391,739
<u>Stockholders' Equity</u>						
Total Stockholders' Equity	275	(506)	156,661	252,538	339,230	416,047

THE COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF BELLSOUTH BSE, INC.)	
FOR AUTHORITY TO PROVIDE LOCAL)	CASE NO. 97-417
EXCHANGE SERVICE)	

O R D E R

INTRODUCTION

On October 1, 1997, BellSouth BSE, Inc. ("BSE") filed its application with the Kentucky Public Service Commission for approval to provide local exchange service in Kentucky. BSE is a wholly owned subsidiary of BellSouth BSE Holdings, Inc. which in turn is a wholly owned subsidiary of BellSouth Corporation ("BellSouth"). BellSouth Telecommunications, Inc. ("BST") is the largest incumbent local exchange carrier ("ILEC") in Kentucky and is also a wholly owned subsidiary of BellSouth. In connection with this application, BSE and BST have submitted their interconnection agreement for approval pursuant to 47 U.S.C. § 252(e).

AT&T Communications of the South Central States, Inc. ("AT&T"), the Southeastern Competitive Carriers Association ("SECCA"), MCI Telecommunications Corporation and MCImetro Access Transmission Services, Inc. ("MCI"), and the Kentucky CATV Association, Inc., d/b/a Kentucky Cable Telecommunications Association ("KCTA") intervened. The Intervenor claim, among other things, that provision of local exchange service by BSE in BST territory would have anti-competitive effects, enabling BellSouth to avoid the legal restrictions imposed on BST as an ILEC. The Intervenor also claim that

BSE services, subsidized by BST by means of less than arm's-length transactions, would be priced below cost and would force legitimate competitors out of the market. On April 24, 1998, the Commission conducted a hearing on the matter, and subsequently BSE, AT&T, and SECCA and MCI jointly, submitted briefs.

CERTIFICATION REQUIREMENTS

BSE contends that its application meets the Commission's requirements for certification as a competitive local exchange carrier ("CLEC"). BSE asserts it has demonstrated to the Commission that it has the technical, managerial, and financial abilities to provide adequate service pursuant to KRS 278.020; it has submitted an interconnection agreement, 47 U.S.C. § 252; and it has submitted a local service tariff pursuant to KRS 278.160.¹

The intervenors herein contend that BSE lacks the financial resources to operate as a CLEC because it must depend upon the resources of its parent company. As BSE points out,² the Commission has certified other CLEC applicants that initially relied upon the resources of their parent companies. AT&T argues that BSE also lacks technical and managerial resources and depends upon the experience and expertise of employees of its affiliates.

¹ Post Hearing Brief of BellSouth BSE, Inc., filed May 26, 1998 ("BSE Brief"), at 1-2.

² BSE Brief at 2.

In Administrative Case No. 370,³ pursuant to its authority under KRS 278.512 to exempt certain telecommunications carriers and products from statutory and regulatory requirements, the Commission determined that requiring CLECs to file applications to begin operations is no longer necessary to protect the public. CLECs, as such, possess neither market power nor own local exchange bottleneck facilities; moreover, there is no need for the Commission to monitor their financial stability to ensure their continued existence, since financial failure of a CLEC would not deprive customers of their carrier of last resort.⁴ Accordingly, BSE is technically correct: its filings at the Commission are sufficient, pursuant to current regulatory requirements for CLECs, to enable it to begin operations in Kentucky. However, as the intervenors point out, BSE is not merely a CLEC. It is an affiliate of BST, Kentucky's largest incumbent local exchange carrier, and the evidence demonstrates that its operations are intricately intertwined with those of this powerful affiliate. It is the alleged potential for anti-competitive behavior and distortion of the competitive local exchange market that are the problematic issues here.

Thus, while the dependence of BSE on its parent is not technically relevant to certification per se, the close relationship between BSE and BST does raise concerns regarding the operational separation of the entities and the resulting potential for gaining an unfair pricing advantage. If BSE acquires services at a discount from BST and those services are delivered in the same manner as if the transaction never occurred, then it

³ Administrative Case No. 370, Exemptions for Providers of Local Exchange Service Other Than Incumbent Local Exchange Carriers, Order dated January 8, 1998 ("Administrative Case 370 Order").

⁴ Administrative Case 370 Order, at 2.

appears that overhead expenses associated with providing service incurred by a typical CLEC may never be realized by BSE. The conceptual framework for the development of competition and the incentives to operate more efficiently and reduce costs could thereby be negated by a variant of price arbitrage.

**INCONSISTENCY WITH THE PURPOSES OF
THE TELECOMMUNICATIONS ACT OF 1996**

The Intervenor argues that, if BSE provides service in BST territory, BST could subsidize BSE's prices, enabling BSE to provide BST services on a retail basis at rates that neither earn a profit nor cover BSE's costs. The resulting price squeeze would force other CLECs, which will need to make a profit to survive, out of the market. AT&T contends that Congress foresaw that an ILEC might attempt to be a CLEC as well as an ILEC and therefore enacted 47 U.S.C. § 251(h), which provides that, when a comparable carrier substantially replaces an ILEC in its market, the obligations placed on an ILEC by the Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996) (the "Act") must apply.⁵ MCI and SECCA state that, in fact, to consider BSE a CLEC in areas served by BST would be to "ignore the only reasonable definition of a CLEC – a local exchange carrier that competes against the entrenched incumbent for customers."⁶ BSE, the Intervenor contends, would not actually "compete" with the incumbent BST. MCI and SECCA point out that, in hearings on BSE certification in South Carolina, BSE witness

⁵ AT&T Brief at 11.

⁶ SECCA and MCI Brief at 1.

Robert C. Scheye stated outright that BSE does not "really want to compete with BST."⁷

The Intervenor not only claim that there is no real distinction between BST and BSE; they also argue that the public will perceive no difference between BSE and BST. Both carry the name "BellSouth" and will use the BellSouth logo.

The real purpose of BSE's existence, the Intervenor claim, is to enable BellSouth to provide local exchange services absent the restrictions placed upon it by the Act as an ILEC in possession of bottleneck facilities. BSE will, for example, not be required to make retail services available for resale to CLECs at wholesale rates pursuant to Section 251(c)(3) and (4) of the Act.

BSE argues, among other things, that allegations regarding potential anti-competitive behavior on its part are only "conjecture,"⁸ and that there are adequate remedies to deal with such activities if they occur.⁹ BSE also contends it would be economically irrational to operate in a less than profitable manner.¹⁰ The latter argument, however, does not take into account the ultimate benefit to BellSouth of eliminating competitors from the local market; and while it is true that anti-competitive behavior of the nature predicted by the Intervenor has not yet occurred, the Commission finds that the

SECCA and MCI Brief at 3, citing Tr. 17, Before the South Carolina Public Service Commission, BellSouth BSE Application for a Certificate of Public Convenience and Necessity to Provide Local Exchange Telecommunications Services, Nov. 5, 1997, Docket No. 97-361-C.

⁷ BSE Brief at 3.

⁸ BSE Brief at 4.

¹⁰ BSE Brief at 7, 8.

potential for such behavior would be greatly exacerbated by granting BSE the authority it seeks. Further, although remedies for violation of federal law do, of course, exist, this Commission does not routinely oversee the business activities of CLECs for the very reason that they do not possess the market power of an ILEC such as BellSouth.

CONCLUSIONS

The Commission regulates telecommunications services in the public interest. See, e.g., KRS 278.512(1)(c) ("[t]he public interest requires that the Public Service Commission . . . regulate and control the provision of telecommunications services to the public in a changing environment, giving due regard to the interests of consumers, the public, the providers of the telecommunications services, and the continued availability of good telecommunications service"). Public interest determinations "require consideration of all important consequences including anti-competitive effects." Denver & Rio Grande W.R.R. v. United States, 387 U.S. 485, 492 (1967). See also FCC v. RCA Communications, Inc., 346 U.S. 86, 94 (1953) ("There can be no doubt that competition is a relevant factor in weighing the public interest"). Section 252(e)(2)(A)(ii) of the Act provides that a state commission may reject an interconnection agreement on the ground that its implementation would not be "consistent with the public interest, convenience, and necessity."

The Commission finds that the public interest concerns raised by the intervenors herein are grave ones justifying rejection of the BST/BSE interconnection agreement and denial, in part, of BSE's application to provide local exchange services in Kentucky.

IT IS THEREFORE ORDERED that:

1. BSE is granted the authority to provide intrastate telecommunications services as described in its application but only in areas outside the franchised service territory of BST.

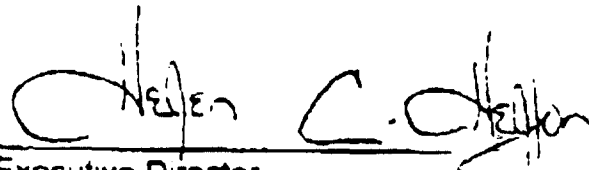
2 The interconnection agreement between BSE and BST is rejected.

3 BSE shall incorporate the restriction on its service area in its tariff

Done at Frankfort, Kentucky, this 8th day of June, 1998.

By the Commission

ATTEST:


Executive Director

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